2. *Economic Environment*

The economic environment is the sum total of the economic conditions and the nature of the economy in which the business has to operate and compete. This will include the nature of the economy, the direction in which it is progressing, the availability of resources (labour, capital etc) and the conditions of the market as well. All these factors in combination create the economic environment for a firm.

The economic environment will dictate a lot of the decisions of the firm. The size of the market will depend on the economic environment. The purchasing power of a potential customer will also depend on factors of the economic environment like income levels, savings, credit availability etc.

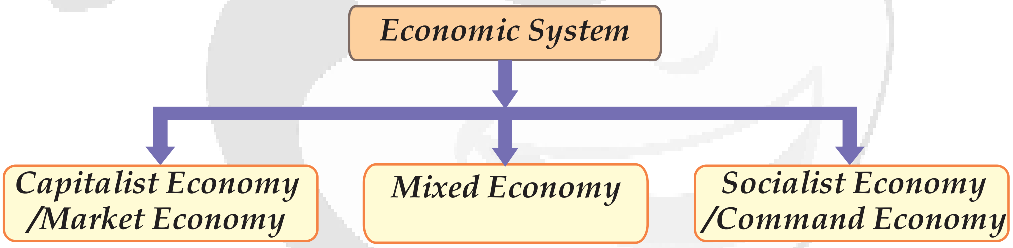
Factors Affecting the Economic Environment

The firm has no control over the economic environment in which it must operate. It is an external macro factor. While it cannot be controlled by the firm it can be studied. So it is important to know the factors which affect the economic environment and how they may impact the firms.

2.1 Economic System

An economic system must define what to produce, how to produce it and for whom to produce it. Depending on the products produced and the environment, certain economic strategies will be more successful than others.

The world economy is primarily governed by three types of economic system :



India has adopted the mixed economy system which implies co-existence of public sector and private sector.

(i) Capitalist Economy/Market Economy : A market economy is very similar to a free market. ***The government does not control vital resources, valuable goods or any other major segment of the economy.*** In this way, organizations run by the people determine how the economy runs, how supply is generated, what demands are necessary, etc.

Where markets allocate resources through the **price mechanism**. An increase in demand raises price and encourages businesses to use more resources into the production of that good or service. The quantity of products consumed by people depends on their income and income itself depends on the market value of an individual's work. In a free market economy there is a limited role for the government, indeed in a pure free market system, the government limits itself to protecting **property rights** of people and businesses using the legal system and protecting the value of money or the value of a currency.

Hong Kong has been seen as an example of a free market society.

(ii) Socialist Economy/Command Economy : *In a planned or command system associated with a socialist or communist system, scarce resources are* ***owned by the government****.* The state allocates resources, and sets production targets and growth rates according to its own view of people's wants. Market prices play little or no part in informing resource allocation decisions and queuing rations scarce goods.

In a command economy, the government controls all economic activity. One example of a command economy is communism. In a government-directed economy, the market plays little to no role in production decisions. Command economies are less flexible than market economies and react slower to changes in consumer purchasing patterns and fluctuations in supply and demand.

(iii) Mixed Economy : *In a mixed economy, some resources are owned by the* ***public sector*** *(government) and some are owned by the* ***private sector****.* The public (or state) sector typically supplies public, quasi-public and merit goods and intervenes in markets to correct perceived market failure. Nearly all economies in the world are mixed although that mix changes over time for example as some industries are privatised (sold to the private sector) or nationalized (taken back into state ownership).

In the most common types of mixed economies, the market is more or less free of government ownership except for a few key areas like transportation or sensitive industries like defense and railroad.

However, the government is also usually involved in the regulation of private businesses. The idea behind a mixed economy was to use the best of both worlds – incorporate policies that are socialist and capitalist.

To a certain extent, most countries are mixed economic system. For example, India and France are mixed economies.

Economic Planning

Economic Planning is the process by which key economic decision are made or influenced by central government. It is a continuous process which involves decision or choosing pertaining to alternative way of utilizing the available resources for achieving particulars goals during specific time period in the future.

In an economy like India, the basis socioeconomic problems like poverty, unemployment, stagnation in agricultural and industrial production and inequality in the distribution of income and wealth can hardly be solved within the framework of an unplanned economy. Planning is required to remove these basic maladies.

> ***In the words of H. D. Dikinson*** *: "Economic planning is the making of major economic decisions - by the conscious decision of a determinate authority, on the basis of a comprehensive survey of a country's existing and potential resources and a careful study of the needs of the people."*

Objectives of Economic Planning

In India, the First Five year plan began in the year 1951-52. Although the objectives of these plans were different, we can identify some of the basic long-term and broad objectives of Indian planning. These are :

(i) **Raising The Growth Rate :** The economic planning in India was to bring about rapid economic growth through the growth in agriculture, industry, power, transport and communications and different other sectors in our economy. Further, the growth in real national income was considered to be the basis for an increase in per Capita real income and an improvement in the physical quality of life for, the maximum number of people.

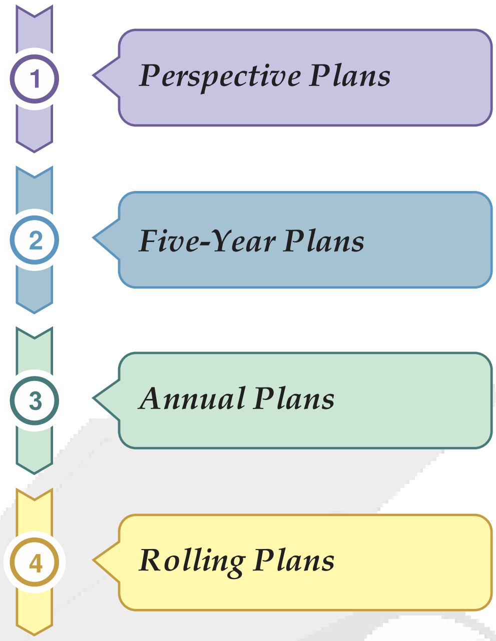
(ii) **Raising the Investment-Income Ratio :** Growth in investment as a proportion of national income was also one of the important long-term objectives of Indian five year plans.

(iii) **Removing Unemployment :** Removal of unemployment and underemployment can be regarded as a precondition for the elimination of poverty.

(iv) **Reducing the Rate of Poverty :** Various plan documents have all along indicated that the policy of the Government of India is to reduce the rate of poverty. The problem of poverty has been conceived as one of low productivity of a large section of the people. Hence, to remove these handicaps of the poor and to rate them in the growth process, alleviation of poverty became one of the broad objectives of Indian planning. So, the long run objective was to free the economy from the vicious circle of poverty which encircles the economy, not only with poor purchasing power, low savings, low capital formation, low productivity and low level of national output, but also with a poor physical quality of life.

(v) **Reducing Income Inequalities :** Income and wealth inequalities arising out of industrialization and growth were far more complex. The Planning Commission felt the need for imposing some restrictive and fiscal measures e.g., by imposing higher rates of direct taxes on high incomes, to tackle this problem. Further, to reduce the disparity between urban and rural sectors, the Planning Commission suggested various measures to raise agricultural productivity, development of agro-based industries, a fair price to farmers for their products, etc.

Types of Economic Plan



Economic planning can be divided into four types such as :

1. ***Perspective Plans :*** *Perspective plan is a long-term plan. Generally, it is formulated for a period ranging from 15 years to 20 years.*
2. ***Five-Year Plans :*** *Five-years plans as their name indicate are designed for a period of five years. It is an integral part of perspective plan.*
3. ***Annual Plans :*** *Annual plan is a part of five-year plan. It is prepared year-wise. So for each five-year plan, five annual plans will be prepared in a detailed manner.*
4. ***Rolling Plans :*** *Rolling plans do not have a fixed period of time. These plans have only duration and move forward. As it moves forward the year, which was completed, is deleted and one year is added at the end.*

Five Year Plans

The concept of economic planning in India is derived from the Russia (then USSR). India has launched 12 five year plans so far. First five year plan was launched in 1951. Now the present NDA government has stopped the formation of five year plan. So 12^{th} five year plan would be called the last five year plan of India.

Table : Duration of the Five Year Plans

Five Year Plan	Duration
First Five Year Plan	1951 to 1956
Second Five Year Plan	1956 to 1961
Third Five Year Plan	1961 to 1966
Fourth Year Plan Holiday	1966 to 1969
Fourth Five Year Plan	1969 to 1974
Fifth Five Year Plan	1974 to 1979
Sixth Five Year Plan	1980 to 1985
Seventh Five Year Plan	1985 to 1990
Eighth Five Year Plan	1992 to 1997
Ninth Five Year Plan	1997 to 2002
Tenth Five Year Plan	2002 to 2007
Eleventh Five Year Plan	2007 to 2012
Twelfth Five Year Plan	2012 to 2017

First Five Year Plan :

- It was made for the duration from 1951 to 1956.
- It was based on the Harrod- Domar model.
- **Its main focus was on the agricultural development of the country.**
- This plan was successful and achieved growth rate of 3.6% (more than its target)

Second Five Year Plan :

- It was made for the duration from 1956 to 1961.
- It was based on the P.C. Mahalanobis Model.
- **Its main focus was on the industrial development of the country.**
- This plan was successful and achieved growth rate of 4.1%.

Third Five Year Plan :

- It was made for the duration from 1961 to 1966.
- This plan is called 'Gadgil Yojna' also.
- **The main target of this plan was to make the economy independent and to reach self- active position of take-off.**
- Due to china war, this plan could not achieve its growth target of 5.6%

Fourth Year Plan Holiday :

DID YOU KNOW ?

The duration from 1966 to 1969 is known as the plan holiday because no five year plan could be made due to Indo-Pakistan war and failure of third plan.

- The duration of plan holiday was from 1966 to 1969.
- The main reason behind the plan holiday was the Indo-Pakistan war and failure of third plan.
- **During this plan annual plans were made and equal priority was given to agriculture its allied sectors and the industry sector.**

Fourth Five Year Plan :

- Its duration was from 1969 to 1974.
- There were two main objective of this plan i.e. growth with stability and progressive achievement of self- reliance.
- **During this plan the slogan of "Garibi Hatao" is given during the 1971 elections by Indira Gandhi.**
- This plan failed and could achieve growth rate of 3.3% only against the target of 5.7%.

Fifth Five Year Plan :

- Its duration was 1974 to 1979.
- **In this plan top priority was given to agriculture, next came to industry and mines.**
- Overall this plan was successful which achieved the growth of 4.8% against the target of 4.4%.
- The draft of this plan was prepared and launched by the D.P. Dhar. This plan was terminated in 1978.

Rolling Plan :

DID YOU KNOW ?

The Janta Party Government terminated the fifth five year plan in 1977-78 and launched its own sixth five year plan for period 1978-83 which is known as the Rolling Plan.

This plan was started with an annual plan for 1978-79 and as a continuation of the terminated fifth year plan.

Sixth Five Year Plan :

- Its duration was from 1980 to 1985.
- **The basic objective of this plan was poverty eradication and technological self -reliance.**
- **It was based on investment yojna, infrastructural changing and trend to growth model.**
- Its growth target was 5.2% but it achieved 5.7%.

Seventh Five Year Plan :

- Its duration was from 1985 to 1990.
- Objectives of this plan include the establishment of the self- sufficient economy, opportunities for productive employment.
- For the first time the private sector got the priority over **public sector.**
- Its growth target was 5.0% but it achieved 6.0%.

Annual Plans : *Eighth five Plans could not take place due to volatile political situation at the center. So two annual programs are formed in 1990-91 and 1991-92.*

Five Year Plans before the Liberalization

Eighth Five Year Plan :

- Its duration was from 1992 to 1997.
- **In this plan the top priority was given to development of the human resources i.e. employment,**
- **Education and public health.**
- During this plan Narsimham Rao Govt. launched New Economic Policy of India.
- This plan was successful and got annual growth rate of 6.8 and against the target of 5.6%.

DID YOU KNOW ?

During the Eighth Five Year Plan (1992 - 1997), the New Economic Policy-1991 of India was launched under the supervision of union of former Finance Minister Dr. Manmohan Singh and former Prime Minister Narasimha Rao.

Ninth Five Year Plan :

- Its duration was from 1997 to 2002.
- **The main focus of this plan was "growth with justice and equity".**
- **It was launched in the 50th year of independence of India.**
- This plan failed to achieve the growth target of 7% and grow only at the rate of 5.6%.

Tenth Five Year Plan :

- Its duration was from 2002 to 2007.
- **This plan aims to double the per capita income of India in the next 10 years.**
- It aims to reduce the poverty ratio 15% by 2012.
- Its growth target was 8.0% but it achieved only 7.2%.

Eleventh Five Year Plan :

- Its duration was from 2007 to 2012.
- It was prepared by the C. Rangarajan.
- **Its main theme was "faster and more inclusive growth".**
- Its growth rate target was 8.1% but it achieved only 7.9%.

Twelfth Five Year Plan :

- Its duration is from 2012 to 2017.
- **Its main theme is "Faster, More Inclusive and Sustainable Growth".**
- Its growth rate target is 8%.
- It is the current five year plan of India.

2.2 NITI Aayog in India

NITI Aayog or National Institution for Transforming India Aayog is basically a policy think tank of Government of India and State Governments that replaces 65-year old Planning Commission. Union Government of India had announced formation of NITI Aayog on 1st January, 2015.

The NITI Aayog will have a governing council comprising all State Chief Ministers and Lt. Governors of Union Territories and will work towards fostering a 'Co-operative federalism' for providing a "national agenda" to the Centre and States.

NITI Aayog would therefore mean :

(a) A group of people with authority entrusted by the government to formulate/ regulate policies concerning transforming India.

(b) It is a commission to assist government in both social and economic issues.

(c) It is an institute of think tank with experts in it.

(d) It is an body to actively monitor and evaluate implementation of government programmes and initiatives.

Present Members of NITI Aayog

1. Chairperson : Prime Minister Narendra Modi.
2. CEO : Mr Amitabh Kant
3. **Vice Chairperson : Rajiv Kumar**
4. Ex-officio Members : Amit Shah, Rajnath Singh, Nirmala Sitharaman, Narendra Singh Tomar.
5. Special Invitees : Nitin Gadkari, Thawar Chand Gehlot, Piyush Goyal, Rao Inderjit Singh.
6. **Full-time Members : VK Saraswat, Ramesh Chand, and VK Paul.**
7. Governing Council : All Chief Ministers and Lieutenant Governor of Union Territories.

3. Aims and Objectives of NITI Aayog

The following are some of the important aims and objectives of NITI Aayog :

1. NITI Aayog sets its aims to provide a critical directional and strategic input into the development process of the country.
2. NITI Aayog aims to serve as a "think tank" of the government both at central and state levels with relevant strategic and technical advice on key policy matters including economic issues of national and international importance.
3. NITI Aayog now seeks to replace the centre-to-state one way flow of policy framed by the Planning Commission by an amicable settled policy framed by a genuine and continuing partnership of states.
4. The NITI Aayog will also seek to put an end to slow and tardy implementation of policy by fostering better Inter-Ministry co-ordination and better centre-state co-ordination. It will help evolve a shared vision of national development priorities, and foster co-operative federalism, in order to focus on the view that strong states make a strong nation.
5. The NITI Aayog has set it objectives to develop mechanisms to formulate credible plans to the village level and aggregate these progressively at higher levels of government. This Aayog will ensure special attention to the sections of society that may be at risk of not benefitting adequately from economic progress.

6. The NITI Aayog, will create a knowledge, innovation and entrepreneurial support system through a collaborative community of national and international experts, practitioners and partners. The Aayog will offer a platform for resolution of inter-sectoral and inter-departmental issues in order to accelerate the implementation of the development agenda.
7. The NITI Aayog will monitor and evaluate the implementation of programmes, and focus on technology upgradation and capacity building.

2.3 Economic Conditions

The economic conditions of the country also have a huge impact on the firms that exist within the economy. Furthermore, economic conditions are the sum total of many factors that can greatly affect a business. Such factors include GDP of the economy, per capita income, availability of capital, utilization of resources, state of the capital market, interest rates, unemployment levels etc.

> *The economic conditions of a nation refer to a set of economic factors that have great influence on business organizations and their operations. These include gross domestic product, per capita income, markets for goods and services, availability of capital, foreign exchange reserve, growth of foreign trade, strength of capital market etc. All these help in improving the pace of economic growth.*
> *Any improvement in the economic conditions such as standard of living, purchasing power of public, demand and supply distribution if income etc. largely affect the size of the market.*

Business cycle is an another economic conditions define as Product Life Cycle.

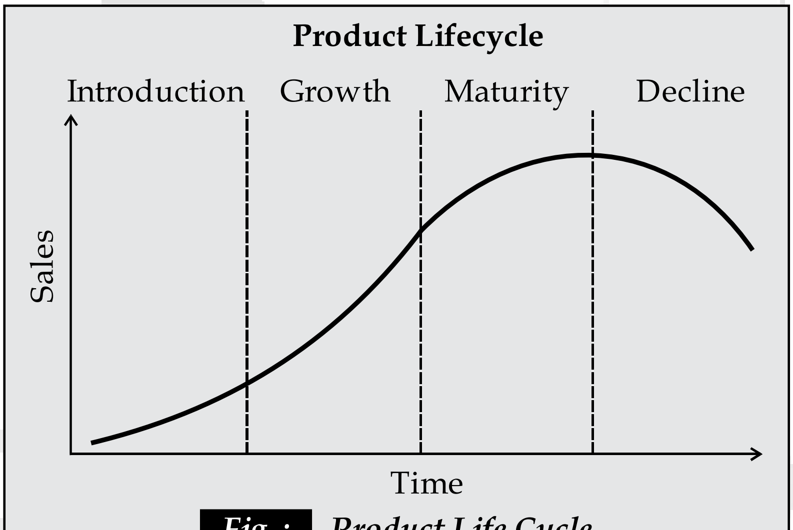


Fig. : ***Product Life Cycle***

The main stages of the product life cycle are :

Introduction : researching, developing and then launching the product.

Growth : when sales are increasing at their fastest rate.

Maturity : sales are near their highest, but the rate of growth is slowing down, e.g. new competitors in market or saturation.

Decline : final stage of the cycle, when sales begin to fall.

2.4 Economic Policies

All business activities and operations are directly influenced by the economic policies framed by the government from time to time. Some of the important economic policies are :

Economic Policies
- *Industrial Policy*
- *Fiscal Policy*
- *Monetary Policy*
- *Foreign Investment Policy*
- *Export–Import Policy (Exim Policy)*

Important Economic Policies

(I) ***Industrial Policy :*** *The Industrial policy of the government covers all those principles, policies, rules, regulations and procedures, which direct and control the industrial enterprises of the country and shape the pattern of industrial development.*

(ii) ***Fiscal Policy :*** *It includes government policy in respect of public expenditure, taxation and public debt.*

(iii) ***Monetary Policy :*** *It includes all those activities and interventions that aim at smooth supply of credit to the business and a boost to trade and industry.*

(iv) ***Foreign Investment Policy :*** *This policy aims at regulating the inflow of foreign investment in various sectors for speeding up industrial development and take advantage of the modern technology.*

(v) ***Export–Import Policy (Exim Policy) :*** *It aims at increasing exports and bridge the gap between expert and import. Through this policy, the government announces various duties/levies. The focus now-a-days lies on removing barriers and controls and lowering the custom duties.*

Monetary Policy

Monetary and Fiscal policies have powerful effects on the economy. The fact that monetary and fiscal policies have the potential to affect the economy suggests that these policies might be used to improve macro- economic performance.

Monetary policy is conducted by the central bank of a country. Fiscal policy is conducted by the Executive and legislative branches of the government and deals with managing a nation's budget.

> ***According to Harry G. Johnson,*** *"There is probably no field of economics in which the writings of economists are so strongly influenced by both current fashions in opinion and current problems of economic policy as the field of monetary policy."*

Monetary policy is only a means to an end and not an end in itself. The aims, objects and scope of monetary policy are conditioned both severally and collectively by the economic environment and philosophy of time. Monetary policy has to be structured and operated within the institutional framework of the money market of the country.

There are two types of monetary policies,

Monetary Policies
- *Expansionary*
- *Contractionary*

> *The policy in which the money supply is increased along with minimization of interest rates is known as Expansionary Monetary Policy. They use expansionary Monetary Policy to lower unemployment and avoid recession. They lower interest rates, buy securities from member banks, and use other tools to increase liquidity.*

> *On the other hand, if there is a decrease in money supply and rise in interest rates, that policy is regarded as Contractionary Monetary Policy. Central banks use contractionary monetary policy to reduce inflation. They have many tools to do this. The most common are raising interest rates and selling securities through open market operations.*

Objectives of Monetary Policy

- Price stability ensures that consumers and businesses can make their economic decisions under **stable and predictable conditions** and thus has a positive impact on economic activity and employment.
- Monetary policy also has short-term effects on the economy, as key interest rates can be raised in **times of economic booms** when the economy threatens to overheat and thus endangers price stability.
- The **disequilibrium in the balance of payments and exchange stability will be maintained.** Monetary policy is to maintain stability in the external equilibrium of the country.
- It leads to violent fluctuations resulting in **encouragement to speculative activities** in the market.
- By Monetary policy central bank of the country tries to **pare down the inflation rate** to a minimum.
- Monetary policy is to ensure that the country has less **unemployed individuals.**

Instruments of Monetary Policy

The instruments of monetary policy are of two types: first, **quantitative, general or indirect**; and second, **qualitative, selective or direct.** The level of aggregate demand through the supply of money, cost of money and availability of credit.

Instruments of Monetary Policy

- *Qualitative Credit Control*
  - *Open Market Operations*
  - *Bank Rate Policy (BRP)*
  - *Cash Reserve Ratio (CRR)*
  - *SLR (Statutory Liquidity Ratio)*
  - *Liquidity Ratio (SLR)*
  - *Repo Rate*
  - *Reverse Repo Rate*
  - *Credit Ceiling*
- *Qualitative Instrument*
  - *Credit Rationing*
  - *Moral Suasion*
  - *Direct Action*

(A) Qualitative Credit Control

1. Open Market Operations : *The open market refers to purchase and sales of short term and long term securities by the RBI in open Market.* In Open market operations the buying and selling of government securities, treasury bills, gold and foreign exchange by a central bank in the open market. Government borrows to finance its deficits. Open market purchases expand the monetary base, thereby raising the money supply and lowering short-terms interest rates.

2. Bank Rate Policy (BRP) : *It is also called* ***Discounted Rate Policy****. The Bank Rate, at which the Central Bank (RBI) rediscount bills or provides advance to commercial Bank against approved securities.* The Bank Rates affects actually availability and the cost of the credit. If the RBI Increase Bank rates than it reduce the volume of commercial Bank borrowing from the RBI.

On the other hand if RBI reduce the Bank Rate borrowing for commercial bank, will be easy and cheaper. This will boost credit creation.

3. Cash Reserve Ratio (CRR) : Every bank is required to keep a certain percentage of its total deposits in the form of a reserve fund in its vaults and also a certain percentage with the central bank. When prices are rising, the central bank raises the reserve ratio.

Banks are required to keep more with the central bank. The volume of investment, output and employment are adversely affected. In the opposite case, when the reserve ratio in lowered, the reserves of commercial banks are raised. When RBI increases the CRR, less funds are available with banks as they have to keep larger portions of their cash in hand with RBI. This means that banks will now have less money to play with. Moreover, Reserve Bank does not pay any interest on the CRR balances.

Increase in CRR sucks money out of the system causing to decrease in money supply. When money supply decreases, the inflation comes down.

4. SLR (Statutory Liquidity Ratio) : Every bank is required to maintain at the close of business every day, a minimum proportion of their Net Demand and Time Liabilities as liquid assets in the form of cash, gold and un-encumbered approved securities. The ratio of liquid assets to demand and time liabilities is known as Statutory.

5. Liquidity Ratio (SLR) : By changing the SLR, the flow of bank credit in the economy can be increased or decreased. Such as, when the central bank decides to control the bank credit so as to control the inflation will raise the SLR. On the contrary, when the economy faces recession, and the central bank decides to increase the bank credit will cut down the SLR.

6. Repo Rate : *The rate at which banks borrow money from the RBI by selling their surplus government securities to RBI is known as "Repo Rate."* Repo rate is short form of Repurchase Rate. Banks provide eligible securities such as Treasury Bills to the RBI while availing overnight loans with a commitment to buy them back at a predetermined price. The interest rate charged on repo transactions is called repo rate.

7. Reverse Repo Rate : *Reverse repo rate is the rate of interest offered by RBI, when banks deposit their surplus funds with the RBI for short periods.* When banks have surplus funds but have no lending (or) investment options, they deposit such funds with RBI. Banks earn interest on such funds.

When RBI increase the Reverse Repo Rate it means that RBI will provide extra interest on Money which it borrow from the bank. An increase reverse repo rate means that bank earn higher return by lending by RBI.

8. Credit Ceiling : Under the credit ceiling, RBI informs the banks to what extent / limit they would be getting credit.

(B) Qualitative Instrument

The Qualitative instrument also known as selective tools of monetary policy. These tools are directed towards quality of credit or the use of credit. The credit objectives may include rationing the credit, directing the flow of credit from least important sectors to the most important sectors, controlling a speculating tendency based on the availability of bank credit.

1. Credit Rationing : *A credit rationing is a measure taken by Central Bank to limit or deny credit based on the investor's credit worthiness*. The Central Bank denies the supply of credit when the investor does not have any collateral to pledge against the loan. Credit rationing is imposed when there is a shortage of institutional credit available to the business sector but the institution tries to capture institutional credit by paying a higher interest rate.

Credit rationing is often applied in the situations where there is a **shortage of institutional credit** available for the business sector, the big and financially strong institutes try to capture a larger portion of the institutional credit.

2. Moral Suasion : *It implies to pressure extracted by RBI on the Indian Banking system without any strict action for the compliance of the rules*. Under moral suasion central bank can issue directive, guideline and suggestion for commercial banks regarding reducing credit supply for speculative purpose.

3. Direct Action : Central bank may take direct action, if his policies are not followed by the commercial banks. Direct action involves direct dealings of central bank with the commercial banks. Direct action may be a refusal on the part of central bank to re-discount the bill of exchange or it may be in the shape of penalty rate of discounting for the banks not following the required policies.

Committees for Monetary Policy

Chakravarty Committee (1985)

- To tame money supply in order to check rising inflation
- To ensure adequate flow of credit to production activity
- To contain fiscal deficit

Narsimham Committee Report-II (1998)

- To improve efficacy by considering financial and economic variables than just financial variables
- To communicate strong signal to market participants
- To make inflation an implicit target than an explicit target

Fiscal Responsibility and Budget Management Act, 2003

- To limit the deficit, so government's borrowings
- To provide investors with information regarding government's financial requirements.
- To manage liquidity on daily basis by injecting and absorbing liquidity
- Restricting the movement of the overnight call rate within a band

Market Stabilization Scheme (MSS), 2004

To ensure a forward-looking transparent monetary policy

- To absorb liquidity on a more enduring basis than daily liquidity management under LAF.

Urijit Patel Committee (2014)

- To anchor inflationary expectations, reduce uncertainty and achieve price stability.
- To guarantee transparency, credibility and accountability in the form of regular and clear announcements.

Fiscal Policy

Fiscal policy refers to the taxation, expenditure and borrowing by the government. The economists now hold the government intervention through fiscal policy is essential in the matter of overcoming recession or inflation as well as of promoting and accelerating economic growth.

> *According to J.M. Culbertson, "By fiscal policywe refer to government actions affecting its receipts and expenditures which we ordinarily takes as measured by the government's net receipts, its surplus or deficit."*

> *According to Otto Eckstein defines fiscal policy as "Changes in taxes and expenditures which aim at short run goals of full employment and price -level stability."*

Fiscal policy has to decide on the size and pattern of flow of expenditure from the government to the economy and from the economy back to the government.

Objectives of Fiscal Policy

The following are the objectives of fiscal policy :

- To maintain and achieve full employment.
- To stabilize the price level.
- To stabilize the growth rate of the economy.
- To maintain equilibrium in the balance of payments.
- To promote the economic development of underdeveloped countries

Types of Fiscal Policy

Fiscal Policy

- *Discretionary Policy*
- *Non-Discretionary Policy*

1. Discretionary Policy

Discretionary policy mean deliberate change in the government expenditure and taxes to influence the level of national output and prices. Fiscal policy generally aims at managing aggregate demand for goods and services.

It may generally take three forms :

(i) Changing Taxes with Government Expenditure Constant : When taxes are reduced, while keeping government expenditure unchanged, they increase the disposable income of households and businesses, further increasing private spending. But the amount of increase will depend on of whom the taxes are cut, to what extent, and on whether the taxpayers regard the cut temporary or permanent.

(ii) Changing Government Expenditure with Taxes Constant : The second method is more useful in controlling deflationary tendencies. When the government increases its expenditure on goods and services, keeping taxes constant, aggregate demand goes up by the full amount of the increase in government spending.

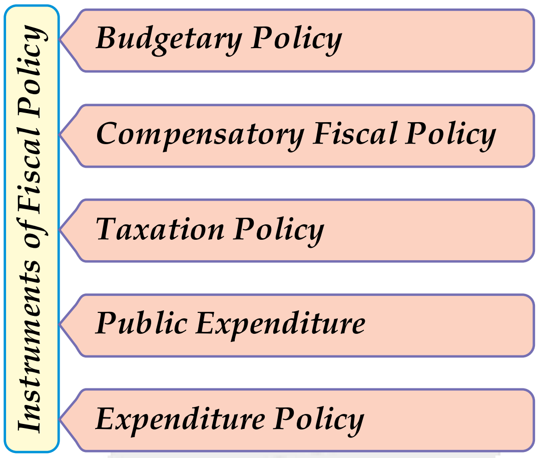
(iii) Variations in both Expenditures and Tax Simultaneously : The third method is more effective and superior to the other two methods in controlling inflationary and deflationary tendencies. To control inflation, taxes may be increased and government expenditure be raised to fight depression.

2. Non-Discretionary Policy

Non-discretionary fiscal policy of automatic stabilizers is a built- in tax or expenditure mechanism that automatically increases aggregate demand when recession occurs and reduces aggregate demand when there is inflation in the economy without any special deliberate actions on the part of the government.

The various automatic stabilizers are corporate profits tax, income tax, excise taxes, old age, survivors and unemployment insurance and unemployment relief payments. As instruments of automatic stabilization, taxes and expenditures are related to national income. Given an unchanged structure of tax rates, tax yields vary directly with movements in national income, while government expenditures vary inversely with variations in national income.

Instruments of Fiscal Policy



(i) **Budgetary Policy (Counter Cyclical Fiscal Policy) :** The budget is the principle instrument of fiscal policy. Budgetary policy exercises control over size and relationship of government receipts and expenditures.

(ii) **Compensatory Fiscal Policy :** The compensatory fiscal policy aims at continuously compensating the economy against chronic tendencies towards inflation and deflation by manipulating public expenditures and taxes.

(iii) **Taxation Policy :** The government gets revenue from direct and indirect taxes. Via its fiscal policy, government aims to keep the taxes as much progressive as possible. Further, judicious taxation decisions are very important for economy because of two reasons:

- Higher than usual tax rate will reduce the purchasing power of people and will lead to decrease in investment and production.
- Lower than usual tax rates would leave more money with people to spend and this would lead to inflation.

Thus, the government has to make a balance and impose correct tax rate for the economy.

(iv) **Public Expenditure :** Public Expenditure are classified into two type :

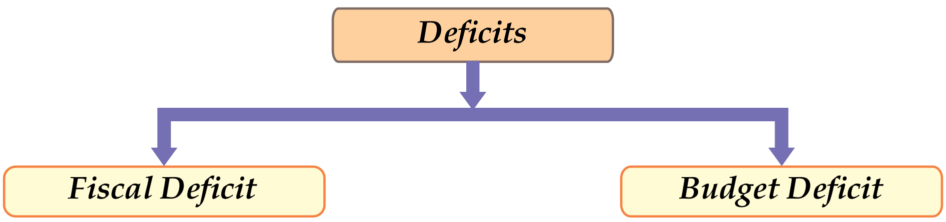
(a) Expenditures on public works such as roads, schools, parks, buildings, airports, post-offices, hospitals, canals and other projects.

(b) Transfer payments, such as interest on public debt, pensions, subsidies, relief payment, unemployment insurance, social security benefits etc.

(v) **Expenditure Policy :** Expenditure policy of the government deals with revenue and capital expenditures. These expenditures are done on areas of development like education, health, infrastructure etc. and to pay internal and external debt and interest on those debts.

Deficits

When government's expenditure exceeds its receipts, it has to borrow to meet the shortfall. This deficit has material implication for the economy as bridging it increases public debt and eats up revenues through higher interest payments.



(i) Fiscal Deficit : The money borrowed by the government is eventually a burden on the people of India, and is, therefore, called public debt. It is split into two heads :

- Internal debt (money borrowed within the country)
- External debt (funds borrowed from non-Indian sources).

Usually the government spends more than what it earns through various sources. This shortfall, which is met with borrowed funds, is called fiscal deficit. Technically, it is the excess of government expenditure over 'non-borrowed receipts' - revenue receipts plus loan repayments received by the Govt. plus miscellaneous capital receipts.

(ii) Budget Deficit : As a result of this, now, the concept of budget deficit in the traditional sense has lost its significance in public finance and is now not reported in the Budget documents of the Government of India.

Ques. *Broad Money has to be sensitized through :* ***(NTA UGC-NET June 2012 P-II)***

(A) CRR *(B) SLR*

(C) Repo Rate *(D) All of the above*

Ans. *(D) Broad Money has to be sensitized through CRR,SLR and Repo Rate.*

Ques. ***Assertion (A) :*** *Internal factors of business environment are controllable factors.*

Reason (R) : *The company can alter or modify such factors to suit the environment.*

Codes : ***(NTA UGC-NET June 2012 P-III)***

(A) Both (A) and (R) are correct. *(B) (A) is correct, but (R) is incorrect.*

(C) Both (A) and (R) are incorrect. *(D) (A) is incorrect.*

Ans. *(A) The factors in internal environment of business are to a certain extent controllable because the firm can change or modify these factors to improve its efficiency.*

Ques. *The concept of 'Rolling Plan' in India was introduced by the*

(NTA UGC-NET June 2012 P-III)

(A) BJP Government *(B) Janta Government*

(C) Congress Government *(D) All of the above*

Ans. *(B) The concept of 'Rolling Plan' in India was introduced by the Janta Government.*

Ques. *Which of the following is not the main objective of Fiscal Policy of India ?*

(NTA UGC-NET Dec. 2015 P-II)

(1) To increase liquidity in economy

(2) To promote price stability

(3) To minimize the in-equality in income and wealth

(4) To promote employment opportunities

Ans. *(1) The main objectives of Fiscal Policy of India are*

(1) To promote price stability

(2) To minimize the in-equality in income and wealth

(3) To promote employment opportunities